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DEVELOPMENTS IN NARRATIVE REPORTING: AN ABI POSITION PAPER

1 INTRODUCTION AND SUMMARY CONCLUSIONS

1.1 This paper examines the current state of narrative reporting in the UK following the abolition of the mandatory Operating and Financial Review in November 2005 and its replacement with the Business Review. It takes account of compliance with the ABI's guidelines on Socially Responsible Investment (SRI) by FTSE All Share companies. Based on monitoring by IVIS, the ABI's voting advisory service, and consultation with members, it considers current best practice and how it might be developed further.

1.2 The IVIS survey shows a further improvement in compliance with ABI guidelines, albeit at a slower pace than last year. Feedback from members suggests that the quality of narrative reporting has generally improved, although high standards are not universal.

1.3 The ABI Investment Committee welcomes this positive response from companies. It considers that narrative reporting is an important communication tool, which helps investors understand the longer term risks and opportunities facing the companies in which they hold stakes. Members believe discussion of these risks and opportunities in narrative reports, including reference to Board oversight of how they are being managed, should be set in the context of a broad view of the financial and non-financial issues facing companies.

1.4 Social, environmental and ethical (SEE) issues are an important dimension of this, but not the only one. Strategic, financial and market risks and opportunities are also key components of narrative reporting. To reflect this, the ABI intends to review and rename its SRI guidelines, launched in 2001, to reflect new developments, including the introduction of the Business Review.

1.5 The essential principle will remain that Boards should confirm they have reviewed and are managing risks and opportunities. However, the emphasis will no longer be exclusively on social, environmental and ethical issues. Where these issues are material, they should be fully integrated into the Board's overall strategic approach to management of risks and opportunities and not treated as a separate "add-on" consideration. The Investment Committee feels this will help investors see these issues in the proper context of the development and direction of the business.

1.6.1 With regard to narrative reporting, investors consider the priority areas for improvement should be the delivery of forward-looking information and non-financial key performance indicators. The Committee would also welcome the provision of more information on how Boards approach their work. The Committee considers that the guidance on narrative reporting[1] developed by the Financial Reporting Council provides a useful benchmark for good practice.

2 **RESPONSE TO ABI GUIDELINES**

2.1 So far this year IVIS has analysed approximately 580 companies for their compliance with the ABI's guidelines on SRI. As the charts in Appendix 1 show, the picture is one of continued improvement. In the FTSE All-Share, the number of companies with No disclosure has dropped from 8% to 6%, while the instances of Full disclosure has risen from 18% to 20%. 62% of all companies now have Moderate or Full disclosure, compared with 59% in 2005, 44% in 2004 and 40% in 2003.

2.2 Although there is a clear trend towards improvement, this year has seen a marked reduction in the rate of improvement compared to last year. For example, last year in the FTSE 100, Full disclosure increased to 60% from 36% in 2004, a jump of 24 percentage points, but this year the increase was only 5 percentage points from 60% to 65%. This slower trend is evident in all the FTSE indices.

2.3 The main reason for companies with Moderate disclosure failing to achieve Full disclosure is the lack of Key Performance Indicators (KPIs) showing how far they have complied with the company's policies on social, environmental, and ethical risks. The other areas where companies generally fail to meet the full guidelines are providing information on the inclusion of SEE issues in Director's training and including SEE issues into remuneration incentives.

3 **BUSINESS REVIEW/OFR**

3.1 The Business Review, which arises out of the EU Accounts Modernisation Directive, now requires companies to provide narrative information on the following areas: a balanced and comprehensive analysis of the development and performance of the company during and at the end of the financial year, a description of the principal risks and uncertainties facing the company, financial and non-financial KPIs, and views on the trends and factors affecting the development, performance and position of the company.

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[1] http://www.frc.co.uk/images/uploaded/documents/Reporting%20Statements%20OFR%20web.pdf

3.2 Despite the variety of names for narrative reports, including Operating and Financial Review, Business Review or Directors' Report, the structure of the majority of reporting is very similar. The general opinion of most investors is that narrative reporting is improving, with some companies producing excellent reports, though high standards are not yet universal.

4 KEY CRITERIA OF GOOD PRACTICE

4.1 Investors see a number of areas as distinguishing the leading reporters. These are: the presentation of forward-looking information on the company's strategy and market environment; the quality of reporting on business units, including risks and future drivers for the unit; the reporting of risks to the company's future value; the presentation of KPIs and key performance targets; information on whether and how Boards have used the data contained in KPIs to monitor and review the effectiveness of their risk management strategies; and, finally, information on the role of the Board and its Committees.

5 FORWARD-LOOKING INFORMATION

5.1 Most companies are good at presenting information on their past and present business drivers, market conditions, operating environment and current regulatory environment. The key aspect that differentiates the best reporters is the forward-looking nature of their disclosures. The best reporters clearly outline how they see the Company's strategy, business drivers, regulatory market and operating environment may change in the future and what steps the Board is taking to position the business to profit from these possible changes to their business environment.

5.2 There appear to be two reasons why some companies do not produce comprehensive forward-looking disclosures. The first is confusion over the current state of safe harbours for Directors making forward-looking statements. Many Directors are unsure what legal protection they are currently afforded under the current legislation. The Companies Bill, which has now received Royal Assent, will provide a safe harbour for Directors on narrative reporting. The ABI supported this change with specific emphasis on forward-looking statements. Members will therefore look to see the change reflected in the scope of future reports.

5.3 The second reason is that some companies believe they would be putting themselves at a competitive disadvantage by providing forward-looking information, especially if their competitors do not. By explaining how directors are positioning the company to meet explicit future competitive and regulatory challenges, these companies believe they are providing information which competitors will exploit.

5.4 ABI members do not wish to put companies under pressure to reveal commercially sensitive information. However, they believe that the example set by companies which do make forward-looking statements, shows that these can add value without compromising business confidentiality. The problem should abate as a critical mass of companies starts making forward-looking reports in the light of the new legislation.

6 IDENTIFICATION OF RISKS

6.1 Since the ABI's guidelines on SRI were first published in 2001, ABI members have encouraged companies to identify and manage their material SEE risks. While most companies include in their annual report key risks to their business, the area that distinguishes the best reporters is the inclusion of material SEE risks. The inclusion of such risks shows that SEE risks are incorporated into mainstream risk management processes and thus are managed in the appropriate way.

6.2 No list can be exhaustive. The key risks will vary from company to company. They may be quite wide-ranging and it is up to Boards in the first instance to identify those of particular relevance to their own company. Examples of risks which companies have listed as material include: the impact of safety and environmental issues on a company's operations, the importance of its workforce being suitably motivated and incentivised, the financial and reputational impact of non-compliance with legislation, and the impact that changes in consumer requirements or preferences could have on the demand.

6.3 It is important for Boards that have analysed SEE risks but have found none to be material, to make a statement to such effect in their annual report. This reassures investors that the Board is monitoring and assessing these risks even though they do not need to be actively managed. Investors derive confidence from confirmation that Boards are regularly analysing these issues.

6.4 While it is important that material SEE issues are covered in the annual report, companies are encouraged to cross-refer to their separate corporate social responsibility reports rather than duplicate detail unnecessarily.

7 KEY PERFORMANCE INDICATORS

7.1 Under the requirements of the Business Review, companies should include both financial and non-financial KPIs in their annual reports. As noted above, the presentation of non-financial KPIs is one area where the majority of companies fail to meet the ABI's guidelines on SRI.

7.2 While one purpose of non-financial KPIs is to enable shareholders and other users of annual reports to establish how the company is managing in practice to deliver on its chosen standards, there is also an important role for narrative reporting in setting out the Board's response to the results contained in the figures. Consideration of KPIs is a useful way for Boards to verify the effectiveness of their strategies for risk management. Where the results show performance is not improving, it would be helpful to have a review of the options and plans for changes that will reverse this.

8 REPORTING ON BUSINESS UNITS

8.1 Investors welcome an extension of narrative reporting to business units. While this usually constitutes information on key operating and financial performance, some companies are now helpfully incorporating the aspects discussed above and providing forward-looking statements, information on material SEE risks and non financial KPIs for each business unit.

9 BOARD OPERATIONS

9.1 Investors would further welcome additional information on the operation of the Board and its Committees. Currently most reports on these issues are compliance statements in response to the Combined Code. Helpful commentary would include a brief description of how in practice the Board sets strategic direction, provides leadership, contributes to the training and motivation of the workforce, manages risks and monitors performance.

9.2.1 Investors would also benefit from greater insight into the workings of the main Board Committees, including a description of the composition, remit and explanation of what issues the Committees had to address during the year.

9.3 It is helpful if companies publish the terms of reference of Board Committees, though this can be best achieved through the website. Where this is the case, companies are encouraged to reference the relevant web page in their annual reports.

10 CONCLUSIONS

10.1 Investors welcome the considerable improvements that have taken place in narrative reporting. They believe this should help promote a more long-term focus with better understanding in the market of companies' strategic objectives and risk management.

10.2 They therefore see narrative reporting as a useful communications opportunity rather than a compliance burden. They stand ready and willing to engage with individual companies about the content of their narrative reports.

10.3 They believe the changes to the liability regime being introduced in the Companies Bill should enable a greater emphasis on forward-looking statements, which will be widely welcomed by shareholders. They would also welcome greater use of non-financial KPIs. In this regard they draw attention to the guidance offered by the Financial Reporting Council[2], which was prepared initially in connection with the introduction of the OFR and continues to mark a useful benchmark for best practice.

10.4 They encourage Boards to lay out briefly how they approach the oversight of the strategic opportunities and risk issues covered in the narrative report.

10.5 Finally, they believe that narrative reporting should cover specific issues relating to business units as well as general issues concerning the entire group and that it should take a holistic view of strategic risks and opportunities rather than be confined specifically to social responsibility. This is not to diminish the importance of CSR issues, which should continue to be included, but to set them in their proper context and relationship to the business as a whole.

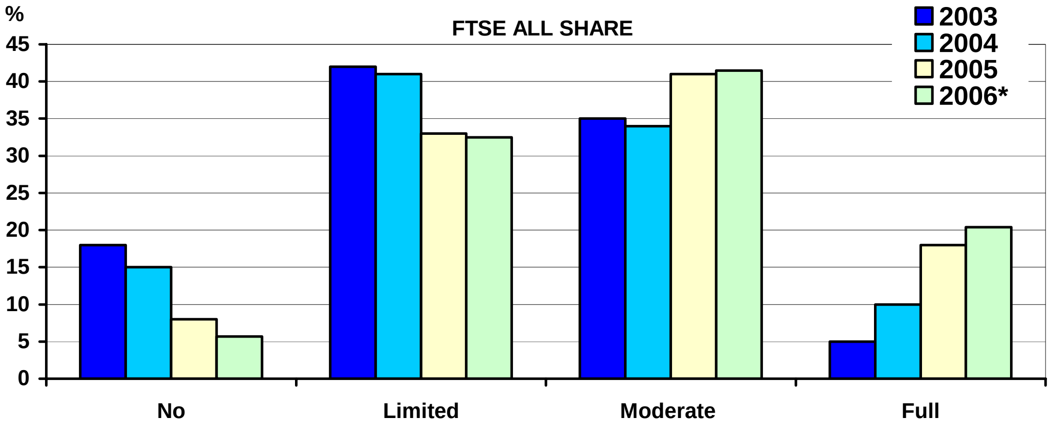
10.6 With this in mind, as well as the formal introduction of the Business Report, the ABI intends to review and rename its Socially Responsible Investment Guidelines introduced in 2001.

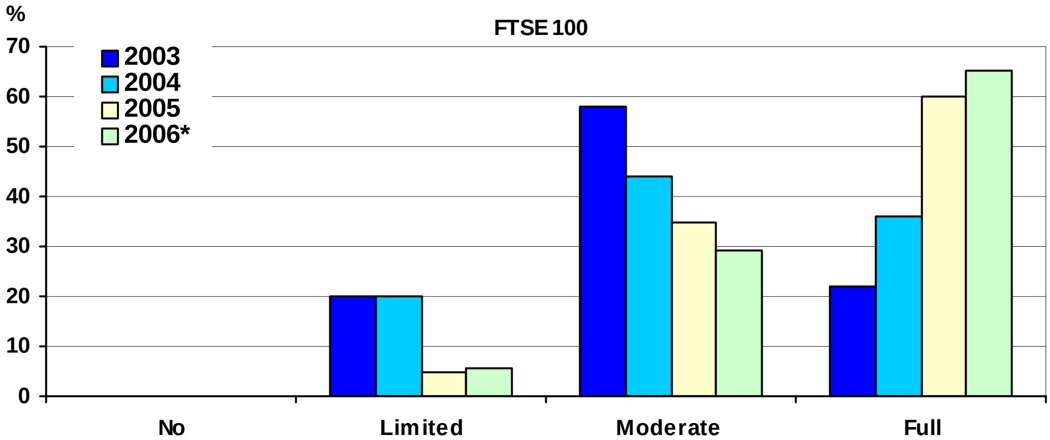
November 2006

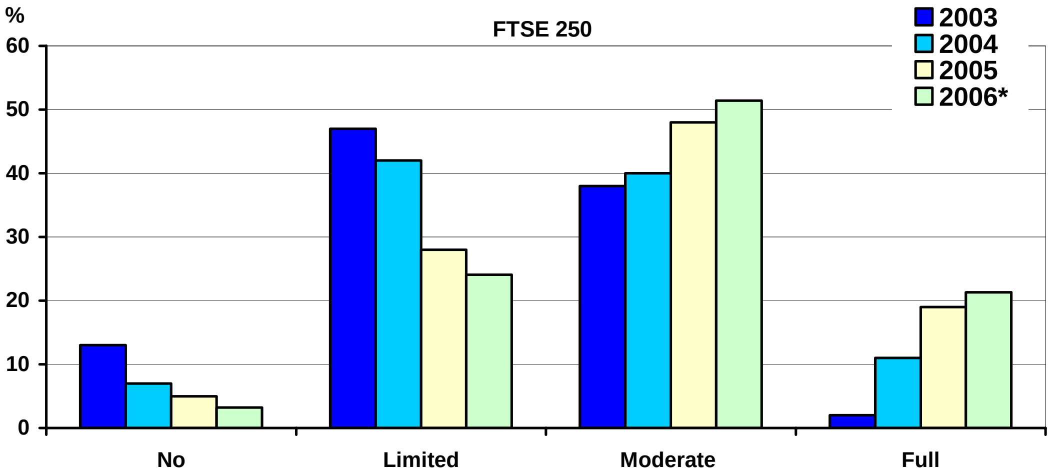
[2] http://www.frc.co.uk/images/uploaded/documents/Reporting%20Statements%20OFR%20web.pdf

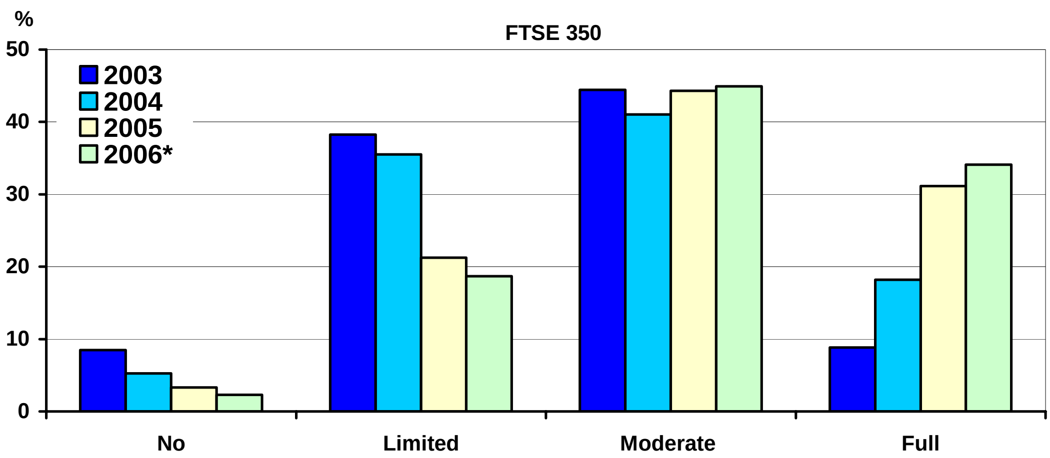
APPENDIX 1

RESPONSE TO ABI GUIDELINES ON SRI








FTSE 350
%
50
40
30
20
10
0
2003
2004
2005
2006*
No
Limited
Moderate
Full

APPENDIX 2

DISCLOSURE CLASSIFICATION FOR ABI GUIDELINES ON SRI

Full Disclosure

1. The company makes clear reference to consideration of SEE matters in the report and accounts
2. There is a clear statement expressing the role of the Board in reviewing SEE risks and whether specific Directors have been charged with responsibility for this area.
3. Clear explanation of the management processes in place going through the company.
4. Listing of risks, with clear link to the business.
5. Brief description of types of policies and procedures in place in relation to risks previously identified.
6. Disclose performance and targets with regards to quantifiable risks.
7. Reference to some form of verification procedures. This may be in the form of independent verification, or through an established system of internal audit.

Moderate Disclosure

1. First four points of Full disclosure would have to be met, although, a lesser degree of detail with regards to management procedures and linkage to the business may be deemed acceptable.
2. At least one of the last three points is detailed within the report or a referenced document.

Limited Disclosure

1. The company makes reference to SEE matters but falls short of criteria for moderate disclosure.

No Disclosure

1. The Company makes no real effort to address SEE related matters in the report and accounts.